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SUBJECT: SCENESETTER FOR SPECIAL ENVOY BOYDEN GRAY'S JULY 22-23
VISIT TO KAZAKHSTAN

Summary

¶1. (SBU) Your visit to Astana will acquaint you more intimately with the dynamic developments in Kazakhstan's energy sector. U.S. and Kazakhstani strategic interests are essentially aligned regarding Kazakhstan's vast energy resources. The Kazakhstanis agree with us that U.S. and Western companies must continue to play a leading role in Kazakhstan's energy exploration and development. The Kazakhstanis also recognize that expanding and diversifying transport routes will best enable them to capture the maximum benefits of their energy wealth. Kazakhstan's importance as an energy supplier is poised to grow dramatically in the coming years as new projects, notably the Kashagan field, commence production and existing ones expand. Crude is the focus for now, with much of the available natural gas reinjected to maximize crude output. With the January signing of an MOU on revised terms for the Kashagan contract, Kazakhstan and the international oil companies are seeking to further enhance their cooperation. Kazakhstan's growing success on the upstream side is leading to greater attention to keeping the mid-stream on track, i.e., to ensuring adequate transport routes for bringing increased volumes to market. Near-term crude production increases are likely to flow by rail through Russia, by tanker across the Caspian to Baku, and through the CPC pipeline, should it be expanded. A trans-Caspian oil pipeline would appear to be the most attractive option to handle later production increases. Privately, the Kazakhstanis agree and have quietly begun planning. However, the public line continues to call for an agreement on delimiting the Caspian before constructing such a pipeline. End Summary.

An Emerging Energy Power

¶2. (SBU) Kazakhstan exported just over 60 million tons of crude oil in 2007 and is expected to be one of the world's top ten oil producers soon after 2015. The country also has significant natural gas reserves -- 1.8 trillion cubic meters is a low-end estimate -- but for now, natural gas exports are relatively small, just 10.2 billion cubic meters in 2007, in large part because gas is being reinjected to maximize crude output. U.S. companies have significant ownership stakes in Kazakhstan's three largest oil and gas projects: Kashagan, Tengiz, and Karachaganak.

¶3. (SBU) Kashagan was the largest oil field discovery since Alaska's North Slope and is perhaps the world's most technically complex oil development project. In January, the Kazakhstani government and the Kashagan consortium's international partners signed an MOU on revised terms for the Kashagan contract, which include a new operatorship model, up to $5 billion in financial compensation to Kazakhstan for several years of production delays and significant cost overruns, and an increased ownership stake and management role for Kazakhstan's state oil and gas company, KazMunaiGas (KMG). Under the new terms, ExxonMobil, Shell, and Total are expected to be

co-operators, each with a specific area of responsibility. The role of Eni, the original sole operator, is being dramatically reduced; it will complete phase one development and perhaps manage phase two onshore activity. Efforts to turn the January MOU into a detailed, formal agreement have not yet succeeded, though in June additional MOUs were signed postponing first crude production from 2011 to 2013, and reconfirming a fixed tax regime for the project. In any event, the January deal appears to have paved the way for further cooperation between Kazakhstan and the international oil companies on new projects, with ExxonMobil, ConocoPhillips, and Chevron all bullish about their prospects. Kashagan's current equity stakeholders are as follows: KMG (16.81%), ExxonMobil (16.66%), Shell (16.66%), Total (16.66%), Eni (16.66%), ConocoPhillips (8.28%), and Inpex (Japan) (8.28%).

¶4. (SBU) Tengiz -- with a 50% Chevron stake, 25% ExxonMobil, 20% KMG, and 5% LukArco - is the world's deepest operating "super-giant" oil field, with the top of the reservoir at about 12,000 feet deep. With the project's second generation expansion coming on line, crude production at Tengiz is increasing this year from 400,000 barrels per day to 540,000. A "future growth option" could increase production by an additional 60 percent by 2015. The Tengiz project is reportedly Chevron's most valuable asset worldwide -- worth $24 billion to the company and yielding $2.7 billion in profit for Chevron in 2007. The Tengiz consortium is currently fighting a $300 million environmental fine levied for on-site storage of several million tons of sulfur. The consortium maintains that it received all the proper permits for sulfur production, and that no permits are necessary -- or available -- for continued sulfur storage. A meeting between Chevron CEO Dave O'Reilly and President Nazarbayev in June apparently produced an acceptable compromise on the fines. With sulfur prices at record levels, Tengiz is storing

$4-6 billions worth of sulfur. Sulfur sales in the first quarter of 2008 netted $120 million, and the stockpile is now being reduced. The major bottleneck is rail transportation capacity.

¶5. (SBU) Karachaganak (with a 32.5% BP Group stake, 32.5% Eni, 20% Chevron, and 15% Lukoil) is one of the world's largest oil and gas condensate fields. Karachaganak produced 10.4 million tons of oil and 12 bcm of gas in 2007.

Bringing Energy to Market

¶6. (SBU) With major production increases on the horizon, Kazakhstan must develop additional transport routes to bring its crude to market. Currently, the bulk of Kazakhstan's oil is exported via Russia, including through the Transneft system and the independently-owned Caspian Pipeline Consortium (CPC) pipeline, in which Chevron holds a 15% interest. Near-term crude production increases are likely to flow by rail through Russia, by tanker across the Caspian Sea to Baku, and through the CPC pipeline, should an agreement be reached with Russia on CPC expansion. The Kazakhstani government is focusing its efforts on the Kazakhstan-Caspian Transportation System (KCTS), which envisions a pipeline (Eskene-Kuryk) moving crude to Kazakhstan's Caspian coast, from where it will be transported by a "virtual pipeline" of tankers to Baku. Using large tankers, it might be possible for KCTS to move up to 1.8 million barrels per day. Kazakhstan and Azerbaijan signed a general Inter-Governmental Agreement on KCTS in August 2007, but the two sides have not yet reached agreement on a more detailed document, with the Kazakhstanis claiming that Azerbaijan is slow-rolling the process.

¶7. (SBU) A trans-Caspian oil pipeline would appear to be the most attractive option to handle production increases expected in the longer-term. Kazakhstani officials agree in private, but in public maintain that an agreement on delimitation of the Caspian Sea among the five Caspian littoral states is a prerequisite - at least politically, if not legally -- for moving forward on such a pipeline. That said, KMG has set up a division to develop trans-Caspian pipeline options, purportedly providing $20 million in funding for its work.

¶8. (SBU) Moving increased volumes of Kazakhstani oil from Baku onward will also be a challenge. It will require expansion of existing pipelines or construction of new ones that run through Georgia, such as Baku-Tbilisi-Ceyhan (BTC) and pipelines to the Batumi and Supsa on the Black Sea coast.

Gas

¶9. (SBU) All indications are that Kazakhstani will only have limited gas for export over the short- and mid-run. Over 90 percent of Kazakhstan's current gas exports flow through Russia, though the country hopes to export 5 bcm annually to China beginning next year. While the Kazakhstani government appears to favor increased gas production, the economics -- together with the geological realities -- argue for reinjecting most gas for now in order to maximize crude production. Tengiz last year produced just 4 bcm of gas, with 2.3 bcm used for domestic consumption and the rest sold to Russia; its second generation expansion this year will result in a production increase, but to just 7 bcm. Kashagan will also principally reinject once it comes on line. These low volumes raise doubts about the economic viability of, for example, building even a small gas pipeline to Turkmenistan that would link up with a trans-Caspian gas pipeline. (One alternative might be swap arrangements that used Kazakhstani gas to satisfy Turkmen commitments to Russia, thus freeing up additional Turkmen volumes to move across the Caspian.)

Welcoming to Investment, But More Assertive

¶10. (SBU) Both the Kazakhstani government and the international companies are committed to an enduring relationship, and Kazakhstan continues to welcome foreign investment in energy exploration and production. Nonetheless, the country has grown increasingly assertive in its energy sector in recent years. Kazakhstan pushed hard to renegotiate the existing Kashagan contract (alleging contract violations by the consortium), seeking much more onerous terms with prospective investors, and aggressively pursuing environmental and tax claims against international oil companies. (See para 5 above for details on the Tengiz consortium's environmental fine.) In October 2007, President Nazarbayev signed legislation which gives the government the right to terminate a subsoil use contact if it determines that a company's actions

violate Kazakhstan's national economic security interests. Nazarbayev has stressed publicly that the legislation would be not be applied retroactively, against contracts that already existed when the legislation went into effect. The Kazakhstani government this May introduced an export duty on crude oil and oil products; however, Kashagan, Tengiz, and Karachaganak are exempt from the duty, as their contracts specify a fixed tax regime. The Prime Minister has told the Ambassador repeatedly in private that these three contracts will have to be ratified by the Parliament in order to retain their stabilized tax regimes.

KazMunaiGas

¶11. (SBU) KazMunaiGas (KMG), Kazakhstan's state oil and gas company, is a vertically-integrated concern with over 30,000 employees and 25 subsidiaries responsible for exploration, extraction, processing, transportation, and sales. KMG is responsible for 16% of Kazakhstan's crude production and 65% of the country's oil transport. It also controls 30% of Kazakhstan's crude refining capacity and 100% of its gas trunk pipelines. In 2007, KMG became the sole owner of Georgia's Batumi oil terminal and purchased a controlling stake in Rompetrol, which owns two refineries in Romania and several hundred gas stations throughout Europe. These acquisitions are important elements in Kazakhstan's efforts to diversify transport routes and should facilitate movement of Kazakhstani oil from the Black Sea onward. KMG First Vice President

Maksat Idenov has ambitious plans for restructuring KMG and implementing administrative reforms that would make the company more manageable, streamlined, and transparent. In May, KMG President Uzakbai Karabalin, who had apparently tried to oust Idenov, was dismissed from his post. Karabalin was replaced by Serik Burkitbayev -- a surprise candidate who during 2003-07 headed Kazakhstan's Oil and Gas Institute, an engineering, research, and design organization.

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